2012 In Review

In history books, 2012 will be described by many as a very complex and contradictory time. Consider the start of the year when Iran was facing rising economic sanctions and U.S. oil prices climbed to over $100 a barrel. Also consider no Strait of Hormuz blockade; up and down Eurozone worries; potential record-breaking harvesting of crops halted by record drought; the Supreme Court upholding 'ObamaCare' along with health care consolidation; restructuring of banks in anticipation of Dodd-Frank legislation; the presidential election, and of course, the 'fiscal cliff.' What we experienced was not anticipated by most of the professional pundits or by the average investor. As I've shared with many clients over the years, "the age of prophecy ended about 2,000 years ago!"

Equities –

The paradox of 2012 was that many agreed that in the long run, bonds would yield lower total returns than in previous decades. Nevertheless these investors, mostly "main street" not "wall street", were not ready to bet that stock returns and other equities would be positive or better than bonds in the short term. As all eyes were on Washington during the fourth quarter of 2012, we saw the high-profile composites such as the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite lose value during the quarter despite having a very solid year. In many reports, and to the chagrin of numerous clients and others that anticipated market losses, this past year we actually saw less market volatility and dramatically more upside than in 2011. Please review the following regarding domestic indices[1]:

Index	**4Q 2012 % Change**	**2012 % Change**	**2011 % Change**
Dow Jones Industrial Average (DJIA)	-2.5%	7.3%	5.5%
S&P 500	-1.0%	13.4%	0.0%
NASDAQ Composite	-3.1%	15.9%	-1.8%
Russell 2000 (small-cap)	1.4%	14.6%	-5.5%
S&P Mid-cap 400	3.7%	16.1%	3.1%[2]

The financial sector, specifically mortgage companies, led the U.S. markets perhaps because they fell so far during the 2007-2009 credit market crash. Along a similar vein, home construction had the most impressive recovery for 2012 – appreciating 84% according to the Wall Street Journal. Please note the following[3]:

Sector	**Sub-sector**	**2012 Performance***
Basic Materials		
	Specialty Chemicals	29%
	Paper	23%
	Coal	-28%
	Gold Mining	-14%
Consumer Goods		
	Home Construction	84%
	Recreational Products	46%

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Sector	Sub-sector	2012 Performance*
Consumer Goods, cont.	Toys	-2%
	Brewers	1%
Consumer Services		
	Home Improvement Retailers	45%
	Travel and Tourism	41%
	Restaurants & Bars	0.4%
	Specialty Retailers	7%
Financials		
	Mortgage Finance	77%
	Full-line Insurance	35%
	Residential REITS	3%
	Mortgage REITS	4%
Health Care		
	Biotechnology	40%
	Medical Supplies	21%
	Pharmaceuticals	10%
	Health Care Providers	14%
Industrials		
	Building Materials and Fixtures	50%
	Business Support Services	23%
	Marine Transportation	2%
	Delivery Services	3%
Oil and Gas		
	Pipelines	16%
	Exploration and Production	4%
	Alternative Fuels	-46%
	Renewable Energy Equipment	-28%
Technology		
	Computer Hardware	19%
	Software	14%
	Electronic Office Equipment	-21%
	Semiconductors	-4%
Telecommunications		
	Mobile Telecommunications	50%
	Fixed Line Telecommunications	9%
Utilities		
	Water	15%
	Alternative Electricity	8%
	Gas Distribution	-4%
	Conventional Electricity	-3%

**Listed in this chart are only the best and worst performers in each sector.*

As it was over the last several years, the business outlook is mixed. Job growth is steady but uninspiring with 155,000 positions created in December. This was in line with the average monthly gain of 153,000 during 2012[4]. We see GDP growth continuing in the 1.5-2% range. According to the Commerce Department December housing starts rose 12% versus November's figures[5]. Most analysts we follow expect the S&P 500's corporate earnings for the fourth quarter of 2012 to rise 2.7% from a year ago – slow but positive. Finally, retailers ended the holiday season with better-than-expected December sales. Sales at stores open at least a year rose 4.8% versus a year ago according to Retail Metrics[6].

Fixed Income –

According to the Wall Street Journal, the 10-year Treasury rate reached its lowest-yield and highest price (thus far) on July 24th at 1.39%. As discussed in previous reports, the U.S. Treasury, as with Europe's Central Bank (ECB), and other central banks in Asia, has adopted a very aggressive "easy money" policy. The cheap dollars owe much to the Federal Reserve's successive rounds of quantitative easing, and the same goes for our trading partners globally[7]. The current Fed policy consists of buying a combined total of $85 billion Treasury and US agency securities per month to keep rates low and create about $1 trillion in additional money supply in our economy. Essentially the U.S., and others, are paying debts with money – and then backs money with debt! Given current historic low interest rates, we project it will cost $259 billion to service this debt out of the anticipated $7.5 trillion federal revenue in 2013[8].

Again, the challenge of debt reduction is global, but, if global institutions lose confidence in U.S. government obligations, interest rates, and our debt service, can skyrocket. As rates rise the value of bonds will fall. Consider the following[9]:

Selected Yields		1/2/2013 Yield %	1/4/2012 Yield %
Market rates			
	Discount Rate	0.75	0.75
	Federal Funds	0 – 0.25	0 – 0.25
	Prime Rate	3.25	3.25
Bank CDs			
	6-month	0.10	0.22
	1-year	0.13	0.34
	5-year	0.70	1.16
U.S. Treasuries			
	3-month	0.07	0.01
	1-year	0.14	0.10
	5-year	0.76	0.88
	10-year	1.84	1.98
	30-year	3.05	3.03

As the search for yield continued last year, the appetite for "junk" bonds – below BBB rating – was a boon for companies to continue to borrow money at very cheap rates. Junk-rated companies issued $353 billion worth of debt through the last week of 2012. That exceeded the previous record of $286 billion set in 2010 by 23%[10]. Interest payments on junk bonds average 6% to 7% while investment-grade debt pays a historically low 2.7%[11].

International Markets –

Performance outside the U.S. was mixed. Some of the emerging markets, which became a focus for many investors, were challenged in 2012, while other more developed economies made dramatic advances. The broad MSCI Emerging Markets Index, which measures performance in 21 countries, rose 15% in 2012 vs. 13% for the S&P 500[12]. China's Shanghai Composite Index ended the year up a sour 3.2% thanks only to a 15% surge in December. Please note the best and worst international equity markets' returns for 2012[13]:

Country/Index BEST Performances		Country/Index WORST Performances	
Venezuela Caracas General	302.00%	Chile Santiago/PSA	-11.10%
Pakistan KSE 100	48.90%	Spain IBEX-35	-4.66%
Greece ATG	33.43%	Portugal PSI 20	2.93%
Thailand SET	35.76%	China SSE Composite	3.17%
Philippines PSE Composite	32.95%	Canada TSX	4.00%
Germany DAX	29.06%	UK FTSE 100	5.84%
Austria ATX	26.94%	USA DJIA	7.26%
Denmark OMXC	26.86%	Brazil Bovespa	7.40%

For Europe the challenges of the debt-ridden south versus the wealthy north continued. Most European markets closed 2012 near where they began with a small bounce from the south. At the end of 2012 another ECB program helped the European markets finish on a strong note, especially Greece. The ECB's posture during 2012 became much more 'activist' – from only taking on a crisis – fighting role to one whose president pledged to do "whatever it takes" to save the euro[14].

Overall, the DJIA has risen each of the last four years and the Morgan Stanley EAFE (international) index rose 3 of the past 4 years.

Commodities –

The Dow Jones – UBS Commodity Index, which tracks 20 materials from crude oil to lean hogs, fell 1.1% in 2012 – the mildest move in its 14-year history[15]. Crude oil closed the year at $91.82/barrel down 7.09%. Natural gas rose 12.11% to $3.351/mm btu, while gold had values increase a nominal 6.96% to $1,674.80/troy oz[16].

Due to last summer's drought, U.S. crop prices rose putting stress on buyers worldwide. Wheat prices increased 19%, soybeans climbed 18% and corn advanced 8%[17].

The Current Picture –

As I write today fixed income rates remain stable, with the 10-year T-rate yielding 1.84% and the 5-year CD paying 1.32%. Commodities are "edging north" with crude oil at $95.56/barrel up 4.07% and natural gas up 6.42% at $3.566/mm btu – a positive for the stock market.

The equity market advance that began last November continues. Note the following[18]:

Index	Year-to-Date Return*
Total Stock Market (formerly Wilshire 5,000)	4.2%
NASDAQ Composite	3.8%
S&P 500	4.2%
S&P Mid Cap 400	5.2%
Russell 2000 (small-cap)	5.1%
DJ Global Index	3.7%
DJ Global Index (ex. US)	3.2%

As of Jan. 22, 2013

As we have mentioned in previous letters, U.S. companies are holding record amounts of cash. Non-financial American corporations, at the end of the third quarter 2012, held $1.74 trillion in cash and other liquid assets – monies that can be immediately invested[19]. As U.S. companies continue to build up their reserves, we note that foreign companies continue to increase investments here. Recently the China Development Bank in a partnership with Lennar Corp invested $1.7 billion in the biggest real-estate expansion in San Francisco since the 1906 earthquake[20].

Looking forward we can see a bright, but selective, GDP expansion worldwide. Consider the following[21]:

Country	2013 est GDP Growth
Russia	3.8%
Brazil	4.0%
Australia	3.0%

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Country	2013 est GDP Growth
Taiwan	3.9%
China	8.2%
South Korea	3.6%
Hong Kong	3.5%
India	6.0%
Mexico	3.5%
Indonesia	6.3%
Columbia	4.4%

Not only China, but many of the above nations are investing in U.S. companies and other stateside assets on an expanding basis.

As in recent years, challenges remain that must be recognized and considered when implementing investment strategies. For domestic investing, U.S. debt and deficits will weigh on economic growth. Budget deficits are projected to add more than $10 trillion to U.S. debt over the next decade. Entitlement spending led by Social Security and Medicare, consumes the majority and an ever increasing percentage of our national budget. The new Affordable Care law could cost $1.2 trillion over the next decade alone.

Globally, there remains the ongoing concern that Japan and the Eurozone nations might fall back into recession. The perennial concern that we hear and fear is the ongoing turmoil in the Middle East and terrorism worldwide.

Going Forward and Investment Management –

Investment management and financial planning seem to have unique characteristics that affect some of the investing public. Somehow our business brings out the entrepreneurial and independent spirit for at least some investors. We have a few clients and know of others who have made very extreme decisions to either go totally defensive, or totally aggressive based on the 24/7 data that we are constantly fed by the media. Of course there is the desire to always "do something" even when an investor knows that changing strategies and investments can realize potential losses and missed opportunities. Yet the psychology behind these actions are real, and it reminds me of the song by Paul Anka and popularly sung by Frank Sinatra, "My Way."

"Regrets, I've had a few, but then again, too few to mention.
I did what I had to do and saw it through without exemption.
Yes, there were times, I'm sure you know,
When I bit off more than I could chew.
But through it all, when there was doubt,
I ate it up and spit it out.
I faced it all and I stood tall;
And did it my way."

Despite the hubris, only 45% of middle-income 'boomers' have determined how much money they would need to save for a decent retirement, according to the Insured Retirement Institute last year[22]. According to a Pew research study 38% of those interviewed ages 35 to 44 are not confident they have enough income and assets for retirement[23]. In the same study about 43% of 45-to 54-year-olds said they feel less confident about their chances of having enough to live on in retirement, compared to 33% just three years ago[24]. Another study by the National Bureau of Economic Research shows that about half of U.S. retirees die with savings of $10,000 or less[25].

There is a better way than "My Way" to deal with retirement planning as well as other noteworthy financial goals. As you know we implement time-tested processes that aid our clients in organizing and achieving specific goals. These include[26]:

- Identify your current financial status
- Formulate your goals and circumstances
- Prepare an investment policy statement based on practical expectations
- Analyze objectives
- Construct a financial/investment plan based upon your values and expectations – while avoiding unnecessary investment risk
- Implement a plan
- Monitor portfolio changes and their effects on a daily basis
- Maintain responsive communications through review sessions, newsletters, etc.

Together lets plan and invest "our way"! We wish you a healthy and successful 2013!

Yours,

George A. Gumbiner

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[2] Investor's Business Daily, "Market Indexes," pg. B13, 1/2/13
[3] Wall Street Journal, "S&P Dow Jones Indices Industry Groups," pg. R2, 1/2/13
[4] The Value Line Investment Survey, "Selection & Opinion," pg. 1157, 1/18/13
[5] Investor's Business Daily, "Apartment Demand Leads Broad Gains in Homebuilding," pg. A1 1/18/13
[6] Investor's Business Daily, "Holiday Retail Sales Beat Dec. Targets, But Results Mixed," pg. A1, 1/4/13
[7] Barron's, "The Other Lance Armstrong," pg. 7, 1/21/13
[8] Barron's, "Not Quite as Good as Gold," pg. 39, 1/21/13
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[11] ibid.
[12] Wall Street Journal, "Emerging Markets Emerge Unevenly as Growth Slows," pg. R5, 1/2/13
[13] Wall Street Journal, "Global Gains," pg. R5, 1/2/13
[14] Wall Street Journal, "In Europe, Investors Confront Familiar Story," pg. R3, 1/2/13
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[26] Marathon Investment Management Brochure